COMPANY RESEARCH AND ANALYSIS REPORT

Netyear Group Corporation

3622

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FISCO Ltd. Analyst
Yuzuru Sato

FISCO

FISCO Ltd.
http://www.fisco.co.jp

Index

Summary

Setting earnings recovery as top priority, Netyear Group to focus on restructuring business foundation in FY3/19

Netyear Group Corporation <3622> operates a digital marketing support business utilizing Internet technologies. Subsidiary Tribal Media House is an industry leader in social media-related analytics and consulting. Former subsidiary rakumo inc., which developed and sold business-use applications, was sold off in August last year so that Netyear could focus its resources on its main business.

1. FY3/18 results

In FY3/18, Netyear saw top-line growth for the first time in three years as net sales rose 4.8% to ¥6,189mn, but still registered an operating loss for a second straight year, reporting a loss of ¥51mn versus a loss of ¥206mn in FY3/17. Aided by active investment in digital marketing by businesses, Netyear was able to grow its top line by boosting sales from projects related to social media and owned media. This failed to bring operations out of the red, however, as not only did expenses on an unprofitable project carried over from the previous year come in higher than expected, losses were also incurred on two more projects, forcing Netyear to add ¥60mn to the allowance for a loss on orders. The Company noted that it has taken steps to improve its project management system and prevent such losses since FY3/17, but that the two new projects on which the losses were incurred were accepted before the new project management system was put in place. The likelihood of any additional losses being incurred at this point is thought to be is relatively low, however, as one of the two new projects on which losses were incurred has already been completed and the other is planned to be inspected and accepted in July. With regard to the impact of the sale of rakumo on FY3/18 results, the Company reported that the sale of the subsidiary reduced group sales by about ¥200mn and added ¥5mn to operating income, while the sale of all its shares in rakumo resulted in a gain of ¥413mn. Thanks to the large extraordinary profit on the sale of rakumo shares, Netyear finished in the black at the net profit level for the first time in two years, with net profit attributable to the owners of the parent coming in at ¥312mn versus a loss of ¥297mn in FY3/17.

2. Forecast for FY3/19

For FY3/19, the Company is forecasting net sales of ¥6,100mn (-1.5% YoY) and operating income of ¥80mn, expecting to move back into the black at the operating income level for the first time in three years. Excluding the small hit to the top line resulting from its sale of rakumo, FY3/19 sales are otherwise expected to finish up slightly. The Company said that its highest priority in FY3/19 is to put the business back on a profitable footing and, towards that end, is looking to eliminate losses on orders starting at the order solicitation process by pricing project bids more appropriately. With the complexity of projects increasing year by year, the Company also plans to step up investment spending on employee training to give employees the skills they need.

3. Growth strategy

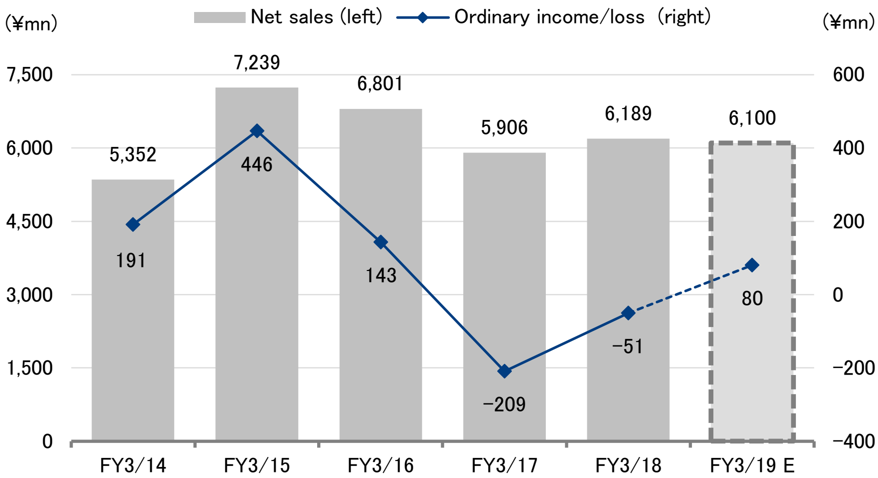
Going forward, the Company's growth strategy calls for focusing on its footprint in the field of digital marketing by creating capital-intensive, stock-type businesses that will generate a recurring revenue stream and drive top-line growth. Currently, only about 13% of total revenues are derived from this area. The Company wants to get this figure up to 50% over the medium to long term and, in doing so, is aiming to not only increase sales and earnings but also increase the stability of its revenue and earnings stream. Towards this end, Netyear started a new "customer success support service" in FY3/19. The new service is a package deal (including system, data analytics, consulting, and content management) aimed at companies that have already installed marketing automation tools*1 and data management platforms*2 but are unable to use them effectively (*see notes below). Netyear already offers installation support services for the marketing automation tools developed by US-based Salesforce.com <CRM> and has seen revenues from this business double over the last year. With this new service it is looking to create a stock-type business that will generate a recurring revenue stream. Given the strong prospects for growth in digital marketing-related fields, we believe this represents a major business opportunity for a company like Netyear whose business expansion efforts are focused on this area.

*1 Marketing automation (MA): A framework and mechanism for automating the actions in each of the marketing processes. It records what actions were taken for customers and prospective customers, and this information is then used for the objective of delivering the optimal contents at the optimal timing using the optimal method.
*2 Data management platform (DMP): A platform for ultimately realizing the optimization of action plans, such as for ad delivery, through the integrated management and analysis of information, including big data accumulated on various servers on the Internet, and log data on in-company websites.

Key Points

- Digital marketing support business utilizing Internet technology is its main strength
- Sees FY3/19 earnings moving into the black at operating income level for first time in three years as profitability improvement measures kick in
- Growth plans to focus on creating capital-intensive, stock-type businesses that will generate recurring revenue streams

Result trends



Source: Prepared by FISCO from the Company's financial results

Business overview

Digital marketing support business utilizing Internet technology is its main strength

1. Company profile

The Company's vision is to "Create the future of business digitally and with users. Everything starts from the user experience." It is developing businesses to support companies and communities for the reforms required in the digital age. Specifically, this includes digital marketing consulting, the planning and production of digital content, systems development, and the planning and sales of marketing tools.

Subsidiaries include Tribal Media House, a subsidiary since 2009. Tribal Media House provides marketing support, analytics, and consulting services that make use of social media. Subsidiary rakumo inc., which develops and sells cloud-based applications, was sold in August last year so that Netyear could focus its resources on restoring the profitability of its mainstay digital marketing support business.

2. Business description

The Company's business area is digital marketing, which refers to the marketing techniques in corporate activities that are centered on the website of the client company and that are coordinated with elements such as existing media, marketing, call centers, and stores. These services are for clients such as companies and local governments, and propose and implement new digital marketing strategies to produce the outcomes that the clients want, including improved brand value, sales growth, and the promotion of business transformations.

A characteristic of the Company is that it is engaged in systems development and design with the focus on improving the "user experience (UX)" on the Internet. Here, "user experience" does not refer to the standard meaning in English, but rather indicates what users experience on a company's website, and what they become interested in after experiencing that site. Therefore, the final goal is to improve the "user experience" in order to get customers to purchase products or to become fans of that company.

With the advent of the digital information society, people can obtain the information they need at almost any time and place via the Internet. On top of promoting marketing and brand strategies, businesses are placing even more importance than before on heightening user experience, which serves as a point of interaction with customers on the company website. For businesses, this has heightened the importance of their website as a point of contact and the importance of the user experience on those websites, making company websites more important than ever before as a part of marketing and branding strategies. The methods for improving the website user's experience will naturally differ depending on the nature of the client company's business, so each project Netyear undertakes has a different set of requirements and must be customized. Generally speaking, the development time needed for smaller projects might be three months or so while larger projects could take a year. Most of the actual systems development work is outsourced. The value of individual projects varies greatly, running from ¥100,000 at the low end to ¥100mn or more at the top end. The size of individual projects has increased in recent years, though, as they have become increasingly complex with client companies needing their system to interface with other systems or make use of marketing techniques that incorporate data analytics. This plays to Netyear's strengths, however, as its staff includes many with strong planning capabilities and innovative thinking when it comes to marketing.

In addition to its custom project implementation support service, Netyear is also putting effort into selling in-house developed products and products developed by other companies. One example of an in-house product is its social media integrated management tool Engage Manager, developed by Tribal Media House. Software tools developed by third-parties that are sold and installed by Netyear include marketing automation tools from Salesforce.com and Oracle, and Access analytical tools from Google <GOOG> and Adobe <ADBE>. In this relation, the Company noted that it has recently been receiving a growing number of requests to include marketing automation tools in the systems it develops as part of custom projects.

Netyear has provided digital marketing support services for more than 250 companies across a wide range of industries, including retail, manufacturing, finance, and telecommunications services. In terms of size, its client list includes many of the largest and best-known companies in Japan.

Performance trends

Money-losing project carried over from previous year results in operating losses for 2nd straight year, but extraordinary gain from sale of subsidiary puts net profit in the black

1. FY3/18 results overview

For FY3/18, the Company reported net sales of ¥6,189mn (+4.8% YoY), an operating loss of ¥51mn (versus year-earlier loss of ¥206mn), an ordinary loss of ¥53mn (versus year-earlier loss of ¥209mn) and a net profit attributable to the owners of the parent of ¥312mn (versus year-earlier loss of ¥297mn). This was the first sales increase in three years. Despite the second straight year the Company recorded an operating loss, the loss was smaller than the previous year, and Netyear finished in the black at the net profit level for the first time in two years thanks to the ¥413mn extraordinary gain on the sale of a subsidiary.

FY3/18 consolidated results

(¥mn)

	FY3/17		FY3/18				
	Result	% of sales	Forecast	Result	% of sales	YoY	Change
Net sales	5,906	-	6,000	6,189	-	4.8%	283
Cost of sales	5,134	86.9%	-	5,381	86.9%	4.8%	246
SG&A expenses	978	16.6%	-	860	13.9%	-12.1%	-118
Operating income	-206	-3.5%	45	-51	-0.8%	-	154
Ordinary income	-209	-3.6%	43	-53	-0.9%	-	155
Net profit attributable to the owners of the parent	-297	-5.0%	444	312	5.1%	-	610

Note: Forecast is revision announced in August 2017.
Source: Prepared by FISCO from the Company's financial results

The top-line growth in FY3/18 reflects a number of factors. In addition to having to devote fewer resources to completing a money-losing project as it did in FY3/17, Netyear benefited from active investment spending on digital marketing on the part of businesses, which gave it many openings to pitch proposals for the creations of social media and owned media, and offer installation support services for marketing automation tools. Sales at subsidiary Tribal Media House got a boost from large contract wins, including promotional projects that make use of social networking services.

At the nonconsolidated level, sales took a long-awaited turn for the better, rising 4.1% YoY to ¥4,111mn. This put an end to the long downtrend in sales going back to FY3/15, when sales peaked at ¥5,772mn as the largest project the Company has ever handled was booked to sales. Consolidated sales were further bolstered by large projects that powered a 30% jump in sales at Tribal House Media. Pushing sales at Tribal House Media up to nearly ¥2,000mn, these gains easily offset the roughly ¥200mn hit to sales resulting from the sale of rakumo.

Although the Company still reported a loss at the operating income level, operating losses were ¥154mn less than the previous year. The Company attributed the improvement to a number of factors, including higher sales, which added ¥96mn to operating income; improved project profitability, which added ¥98mn; the termination of a new business, which saved ¥50mn; a ¥24mn drop in personnel-related costs as new hiring came down; and a ¥11mn decline in amortization of goodwill. The new business terminated during the year was "popurou," an app service for retailers that was started in 2015. The Company said the shutdown of "popurou" in January 2018 was necessitated by changes in guidelines on the platform side but that the termination of the service had only a small impact on sales.

Factors weighing on earnings during the period included an unexpected ¥34mn increase in losses on the money-losing project carried over from FY3/17, losses on two more projects that forced the Company to add another ¥60mn to the allowance for a loss of orders, and a ¥42mn increase in rental expense stemming from the expansion of floor space used by the head office. As one of the two new projects on which losses were incurred has already been completed and the other is planned to be inspected and accepted in July, the likelihood of any additional losses being incurred at this point is thought to be is relatively low.

Compared with the Company's forecast for FY3/18, net sales came in ¥189mn above plan thanks to large contract wins by Tribal Media House. At the operating income level, Tribal Media House saw earnings rise roughly 50% YoY to around ¥100mn, but consolidated earnings still finished below plan owing to the additional losses incurred on the money-losing project that was carried over from FY3/17 and the losses on the two additional projects mentioned above.

Factors contributing to YoY changes in operating income in FY3/18

(¥mn)

Factors adding to operating income	Amount	Factors reducing operating income	Amount
Increase in sales	+96	Additional losses on money-losing project carried over from FY3/17	-34
Improved project profitability	+98	Additions to allowance for a loss on orders	-60
Termination of new business	+50	Rent increase stemming from increase in floor space	-42
Sale of rakumo	+5		
Decline in amortization of goodwill	+11		
Cutbacks in new hiring	+24		
Cuts in other expenses	+7		

Source: Prepared by FISCO from the Company's results briefing materials

Sale of subsidiary provides financing for future capital spending

2. Financial position and management indicators

The Company's balance sheet at the end of FY3/18 showed total assets of ¥3,203mn, an increase of ¥30mn over the end of FY3/17. The change in current assets reflects a ¥237mn increase in cash and deposits stemming from the sale of the subsidiary and a ¥98mn decline in work in process. The decline in fixed assets reflects a ¥91mn decline in software and ¥22mn decline in goodwill.

Under liabilities, total liabilities of ¥1,141mn were down ¥263mn versus the end of FY3/17. Much of the decline in liabilities stemmed from a ¥160mn decline in interest-bearing debt; other factors contributing to the decline in liabilities include a ¥80mn decline in deferred income and ¥50mn decline in the allowance for a loss on orders. Net assets finished FY3/18 at ¥2,062mn, up ¥294mn from the end of FY3/17. Netyear paid out ¥22mn in cash dividends but this was easily offset by the ¥312mn addition from net profit attributable to the owners of the parent.

Looking now at key management indicators, we note that Netyear was able to strengthen its financial position thanks to the influx of cash from the sale of the subsidiary, boosting its equity ratio from 55.0% at the end of FY3/17 to 63.5%, and lowering its interest-bearing debt ratio from 17.9% to 7.5%. Plans call for the capital acquired from the sale of the subsidiary to be put towards measures aimed at restoring the profitability of the digital marketing support business, employee training and other measures aimed at increasing value-added, and addition spending on sales and marketing.

Consolidated balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18	Change
Current assets	2,495	2,947	2,806	2,753	2,909	156
(Cash and deposits)	1,031	1,463	1,219	1,052	1,289	237
Fixed assets	647	405	369	419	294	-125
Total assets	3,143	3,352	3,176	3,172	3,203	30
Current liabilities	957	1,220	1,046	1,231	1,094	-136
Fixed liabilities	276	159	87	173	46	-127
Total liabilities	1,234	1,380	1,134	1,404	1,141	-263
(Interest-bearing debt)	393	266	179	313	152	-160
Net assets	1,909	1,972	2,042	1,768	2,062	294
(Stability)						
Equity ratio	60.4%	58.4%	63.7%	55.0%	63.5%	
Interest-bearing debt ratio	20.7%	13.6%	8.9%	17.9%	7.5%	
(Profitability)						
ROA (return on assets)	6.8%	13.8%	4.4%	-6.6%	-1.7%	
ROE (return on equity)	3.2%	3.8%	3.8%	-15.8%	16.6%	
Operating income margin	3.5%	6.1%	2.1%	-3.5%	-0.8%	

Source: Prepared by FISCO from the Company's financial results

Outlook

In FY3/19, operating income is expected to finish in the black for first time in three years on profitability improvement measures

1. Overview of profitability improvement measures

(1) Measures aimed at improving project profitability

The operating losses Netyear has recorded in the past two years are directly attributable to losses on specific projects. The losses prompted the Company to begin implementing measures during the course of FY3/18 aimed at improving its project management structure and preventing losses on projects due to delays in development. This included a rigorous, two-stage internal review process (the first review coming at the time the proposal is presented to the client and the second review when the project requirements are finalized). The new project management structure was put in place during FY3/18, but this was too late to prevent losses from being incurred on two projects mentioned previously, as both were undertaken before the new project management structure was put into place.

As a result, the Company got the frequency of losses on projects at 2% of all projects in numerical terms, or roughly the same as the prior year, and got the associated losses in monetary terms (including personnel costs) at around ¥200mn. More importantly, the Company has not incurred any large losses on new projects since the new project management structure was put in place. In April this year the Company took another step to strengthen its project management structure even further with establishment of a specification and quality assurance department to monitor projects in progress. Going forward, the Company is also looking to standardize project procedures and the deliverables resulting from various processes so that they will depend less on the particularities of the individuals involved, eliminate variances in quality from project to project, restrict discounting at the time the order is placed, and otherwise work to eliminate unprofitable projects through careful management of project profitability. When going after orders, the Company said it will also be placing more emphasis on securing large orders as a means of improving the efficiency of both sales and back office operations.

(2) Increasing ability of existing employees to add value

During the past few years the IT industry has suffered a severe personnel shortage, making it difficult to hire qualified people, including experienced workers. The experience of Netyear has been little different. At the same time, the degree of difficulty of projects has been rising rapidly as customers' need to connect to multiple systems and multiple vendors must be brought in to work on projects. To handle these increasingly complex projects, Netyear is not looking so much to bring in new people as it is looking to increase the skill set of existing employees through technical training programs that will get them certified in more areas and allow each employee to add more value. At the same time, the Company will also be working to reduce its employee turnover rate by making further workflow reforms and taking steps to improve its work environment.

(3) Stepping up marketing efforts

Netyear depends mainly on inbound sales at this time but going forward it plans to step up its use of free and paid seminars on digital marketing-related topics in an effort to increase contacts with potential clients and thereby increase the number of opportunities it has to bid on projects in the future. During FY3/18 the Company held a total of 25 seminars versus 18 in FY3/17 and through these additional seminars was able to increase the number of inquiries (i.e., potential clients) by 60%. Based on this success, the Company plans to significantly increase the number of digital marketing seminars it holds during FY3/19 with aim of further increasing the number of inquiries.

2. FY3/19 outlook

For FY3/19, the Company is forecasting consolidated net sales of ¥6,100mn (-1.5% YoY), operating income of ¥80mn (versus year-earlier loss of ¥51mn), ordinary income of ¥79mn (versus year-earlier loss of ¥53mn) and net profit attributable to the owners of the parent of ¥56mn (-82.1%).

The projected decline in sales reflects the loss of ¥130mn in revenues resulting from the sale of rakumo. Excluding this, the Company would be forecasting a modest increase in sales based on expectations of single-digit growth in sales at the parent. Sales at Tribal Media House are expected to be down in FY3/19 because sales were bolstered by the completion of a large project.

On the earnings front, the gains projected at the operating income level reflect the expected turnaround at the parent, which is expected to move out of the red and into the black with operating income coming in around ¥40mn while earnings at Tribal Media House finish down. The gains at the parent will be driven in large part by the project profitability improvement measures discussed previously. The dropout of the money-losing projects that weighed on earnings last year will help; since the losses on these projects totaled ¥200mn last year, the lack of similar losses this year will boost earnings by the same amount. On the expense side, the Company expects only a modest increase in personnel spending as it does not expect to increase staffing by much, but is planning to increase spending on employee training and also on marketing.

FY3/19 consolidated outlook

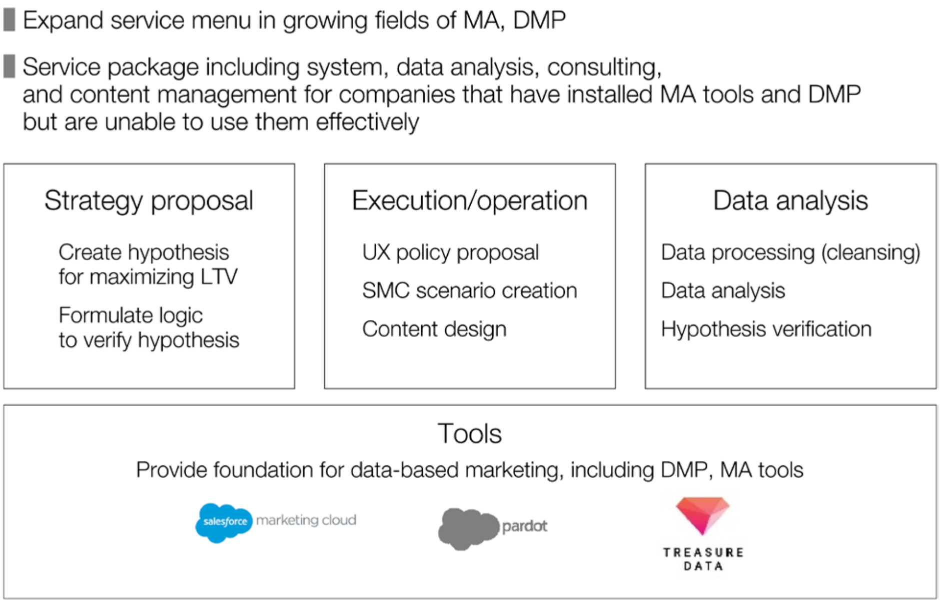
(¥mn)

	FY3/18		FY3/19	
	Result	YoY	Forecast	YoY
Net sales	6,189	4.8%	6,100	-1.5%
Operating income	-51	-	80	-
Ordinary income	-53	-	79	-
Net profit attributable to the owners of the parent	312	-	56	-82.1%
EPS (¥)	44.71	-	8.00	-

Source: Prepared by FISCO from the Company's financial results

Growth initiatives started this year include the startup of a new "customer success support service" that will focus solely on marketing automation and data management platforms. The Company noted that the number of businesses installing marketing automation tools data management platforms has increased in recent years but few appear to be using them effectively. As a result, Netyear decided to offer a service package (including not only the system, but also data analytics, consulting, and content management) so that client companies can make the most effective use the marketing automation tools and data management platforms they have installed. Netyear plans to offer this new support service to companies that have already installed marketing automation tools developed by Salesforce.com and other companies. With this new service, Netyear is looking create a stock-type business that will generate a recurring revenue stream. After gaining expertise in providing this service, the Company will be looking to further expand this new service as one of its in-house services over the medium term.

Customer success support service



Source: The Company's results briefing materials

Meanwhile, Tribal Media House plans to continue investing in its in-house media Funmee!!, an information website designed to attract people with common interests and lifestyle. Following its launch in December 2016, Funmee!! came out with an iOS smartphone app in July 2017. Currently, most of the pictures and articles posted on Funmee!! relate to hobbies such as camping, DIY projects, and driving. The Company is considering various ways to monetize the website, including increasing the number of unique users to increase the media value and bring in advertising revenue, and charging fees for allowing B2C companies use the website to do their own marketing. The Company does not disclose the number of access users, but it appears to be growing steadily. Funmee!! is still in the investment phase, though, so contributions to earnings are still a ways off. Other services Netyear is developing include Co-meeet, released in April 2018. Co-meeet is a fan event promotion support tool designed to help sponsors of offline events generate maximum interest.

Growth plans to focus on creating capital-intensive, stock-type businesses that will generate recurring revenue stream

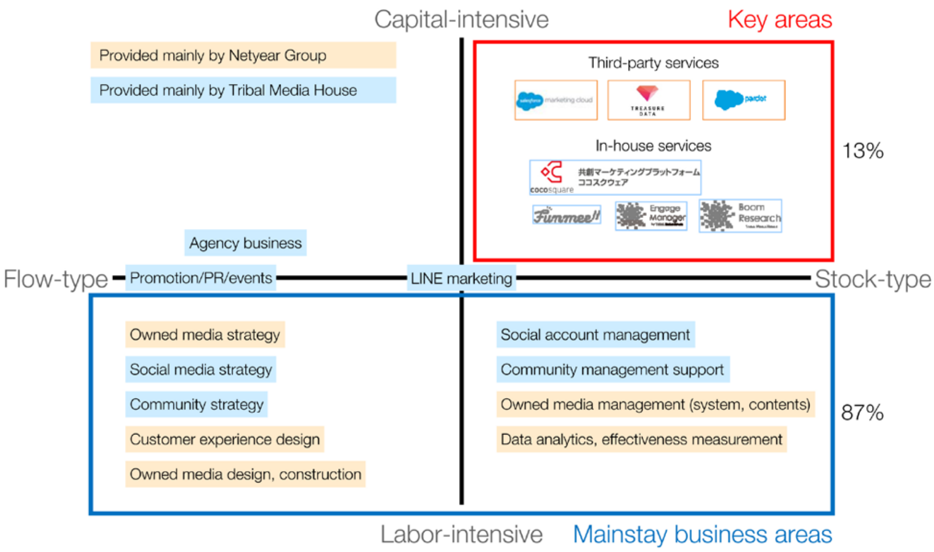
3. Medium-term strategy

With regard to the market environment, the Company said that it expects the market for digital marketing-related products and services to continue to grow over the medium term and, along with advances in technology, this will mean some personal services and low value-added services will be replaced. At the same time, Netyear believes that the increasingly complex needs of client companies will foster even greater demand for high value-added vendors that can handle difficult projects. Based on this outlook, Netyear's strategy calls for going after projects where the level of difficulty is high and, in the process, establishing a track record that will give it a competitive advantage over others in the industry.

At the same time, the Company recognizes that with this type of project—because it is labor-intensive, the scale and specifications differ from project to project, and is susceptible to changes in the economy—there is considerable risk of earnings swinging sharply from one year to the next. And it also recognizes how important it is for a company of its size to have a stable source of revenues in order to sustain growth. For that reason, Netyear is looking to reduce its dependence on this type of labor-intensive work from roughly 90% of revenues at present down to 50%, while at the same time increasing the proportion of revenues derived from capital-intensive, stock-type businesses that will generate a steady stream of recurring revenue up to 50%.

The list of capital-intensive, stock-type businesses that Netyear is engaged in right now is short, including only support services for the marketing automation tools of Salesforce.com and other companies, and some of the services offered in connection with "cocosquare," the co-creation marketing platform operated by Tribal Media House. Netyear does not yet offer any services that are entirely of its own making, but is looking to change that and increase the proportion of sales derived from in-house services with its new customer success support service.

Group service portfolio



Source: From the Company's results briefing materials

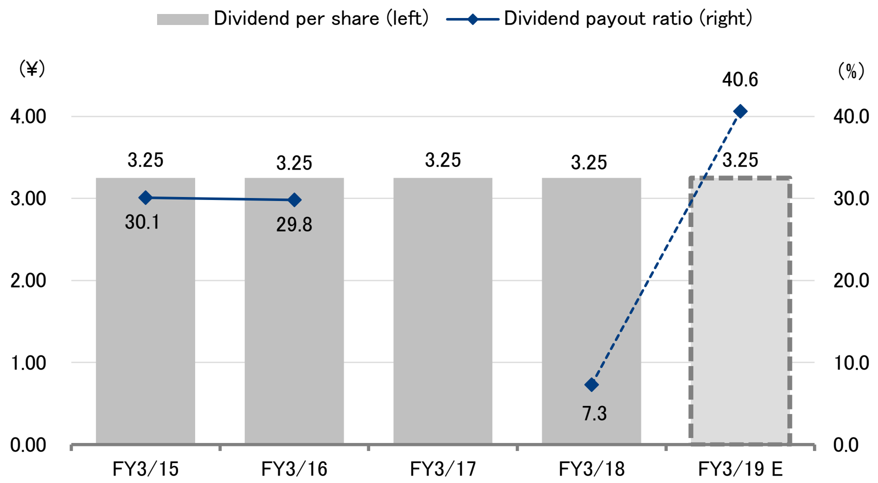
Netyear has been operating in the red for the last two years owing to losses on several projects, but with it now taking steps to improve profitability and push ahead with its growth strategy, we at FISCO expect sales and earnings to take a turn for the better and rise in the years ahead.

Shareholder return policy

Basic policy is to retain internal reserves and to pay dividends stably and continuously

The Company pays dividends in order to return profits to shareholders. Its basic dividend policy is to stably and continuously pay dividends while ensuring it retains the internal reserves necessary to develop its businesses in the future and to strengthen its business structures. For this reason, from FY3/08 onward it has fixed dividends per share at ¥3.25, and is expected to continue for FY3/19. However, the Company intends to introduce performance-linked dividends in the future if it further supplements its internal reserves and obtains a stable cash flow in each fiscal period.

Dividend per share and dividend payout ratio



Source: Prepared by FISCO from the Company's financial results

Information security

Because there are situations in which the Group handles confidential information from client companies and personal information, the Company takes data management very seriously, as evidenced by its receipt of the "Privacy Mark" certification from the Japan Information Technology Services Industry Association in 2005. In terms of actual administration, the Company uses a thin client system* that is designed to prevent external data leaks.

* System architecture that limits the processing done on client terminals to the minimum required and keeps nearly all processing on the server side.

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